

# CITATIONS FOR

## **A Call to Congress for Action: Potentially Harmful Impact of 2704 Proposed Regulations on Succession of Family Businesses and Farms and Why it Must Be Stopped!**

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*1. The scope and amount of the added federal estate tax burden will vary among industries, business class, company policies and distribution histories. The bottom line prejudices family controlled enterprise of every kind and nature and creates an uneven playing field for family entrepreneurs when compared to the non-family competition.*

*2. Representative Sensenbrenner (R-Wisconsin) introduced H.R 6042 which would stop the proposed regulations.*

*3. For example, if Ed owns a business with his two siblings, in real life, he will have no more control over them than would exist among any three people. The civil courts are littered with disputes among family members centered on control of the business. Often, the underlying issues arise from jealousies that have fermented since childhood over issues of control and perceived fairness. If Ed, on the other hand, chose to go into business with non-family members, his estate and gift tax liability to transfer his interests would be substantially lower. On death, less would have to be paid to the IRS in estate tax so that Ed's successors could keep the business. From the standpoint of dollars and cents, a decedent's estate (or the surviving family members) pays the IRS to acquire the decedent's interest. The family business penalty creates an inflated value (i.e., sales price) when compared to the price (taxes paid) by the successors of a business owned among non-family members. Returning to the example of Ed and his siblings, capital is better preserved if the business is sold to outsiders, particularly foreign companies with little or no concern for later federal estate taxes than to retain the business in the family. The family business penalty will create for many the self-fulfilling prophecy of forcing a sale in order to pay the estate tax arising from the assumed liquidation of the company that the family never wanted in the first place. Edwin P. Morrow, III, a co-author to this editorial suggested use of the phrase "family business penalty" which applies to both capital formation and business succession.*

*4. Test of control is 50% capital or profits in the entity or the holding of an equity interest sufficient to cause a full or partial liquidation of the entity or arrangement. Reg. §25.2701-2(b)(5). Family attribution rules are applied to impute control within the family. See, Reg. §25.2702-2(a)(1). These tests and definitions are incorporated into Reg. §25.2704-2 (transfers subject to applicable restrictions) and Reg. §25.2704-3 (transfers subject to disregarded restrictions).*

*5. The minority interest discount is assumed to be greatly reduced if not required to vanish because of the liquidation assumption proposed by the regulation or state law rights allowing a dissociated partner to receive a pro-rata share of the business value. Disregarded restrictions*

*include any restriction that limits the ability to redeem or liquidate an interest in any entity, including (i) any restriction or limitation on the ability to compel liquidation; (ii) any provision that limits the liquidation proceeds to less than the minimum value (pro-rata share of net asset value); (iii) a provision that defers payment beyond 6 months; and, (iv) that permits payment in other than cash or property (with a narrow exception for active trade or business assets if such assets are at least 60% of the entity value). Reg. §25.2704-3(b). The lack of marketability assumption is also reduced because of the short-term period within which the company is assumed to be sold and proceeds distributed. The minority interest discount and the lack of marketability discount have been a part of business ownership valuation for both tax and non-tax purposes for at least five decades. The proposals will reduce or eliminate those discounts depending on the fact of the case. This will increase the estate tax value for a decades-old family business ownership by 20% and for many families by 25%, 30% or more.*

*6. Blockage and built-in gain discounts, for example, have been long accepted and when liquidation is assumed have been allowed as a matter of law. Estate of Dunn v. Comr., T.C. Memo 2000-12, rev'd 301 F.3d 339 (5th Cir. 2002). Discounts at the entity level for loss of a key person or those arising from the nature of underlying assets generally (apart from liquidity of family sub-entities) remain relevant. The appraisal industry will likely develop (while others refute) additional factors that increase the lack of marketability discount when liquidation is assumed. William H. Frazier (Stout Risius Ross, Inc.), Musings on the Theoretical Redemption Rights in Proposed Regulation, 163113-02 (8/8/16) opines that the liquidity assumption will place added debt liability on entities to satisfy cash buy-out rights which will impact value and banking relationships will suffer, as will the ability to borrow to grow the business. Mr. Frazier also observes that "this is a fictional scenario since no operating company, family-owned business or otherwise, has ever enacted such a nonsensical policy. So, in reality, if the proposed regs are finalized as produced, valuation for tax purposes will have no connection to the reality of values in the marketplace." (Quoted at <http://quickreadbuzz.com/2016/08/24/proposed-irc-sec-2704-regulations-released/>.) However, appraisers will likely seek to increase discounts arising from liquidation of controlling interests, which have been included in the analysis of controlling interests in several cases to increase the lack of marketability discount for controlling interests.*

*7. Discounted cash flow or other measures of the net operating income, distribution capacity and history are replaced by a liquidation assumption with a short-term payoff. The minority interest discount is commonly subsumed as part of the discounted cash flow measure of value. A narrow exception for the duration of payment is allowed if at least 60% of the assets are operating assets in a trade or business. While that test provides narrow assistance, it will also create disputes regarding what assets constitute operating assets for a family business. Non-family controlled businesses avoid the problem.*

*8. Steven R. Akers, Esq., Bessemer Trust, Section 2704 Proposed Regulations, August, 2016 (herein called Akers Commentary) authored an extensive memorandum on this subject for tax practitioners. This commentary includes a point-counterpoint in which highly-respected estate practitioners aver contrary views on whether a deemed put assumption at minimum value with a six-month payout applies when restrictions are disregarded. A significant element of dispute among professionals as noted by Mr. Akers is whether a minimum value equal to the liquidation*

value of the entity exists (with an attendant put right) exists to determine valuation for transfer tax and/or whether a put right and minimum value exist solely to determine whether disregarded restrictions exist under the proposed regulations and the consequence of that more limited application. Restrictions that the proposed regulations deem to be “disregarded restrictions” (i.e., ignored for valuation purposes) will be among the most common found in business agreements (including the use of fair market value and payment terms over a workable time period). The minimum value requirement applies at least for purposes of determining whether the agreement or restrictions violate the new requirements. At worst, the minimum value test establishes the base value for an entity controlled by the family. Section 4 of the Akers Commentary reviews the competing construction under the law and input from commentators respecting the pros and cons of this construction. Mr. Akers cites Mitchell M. Gans & Jonathan G. Blattmachr on the Recently Proposed Section 2704 Regulations. August 5, 2016, LISI Archive Message #2241 supporting the deemed put assumption based on entity worth at minimum value, on the one hand, and the opinions of Ronald Aucutt, Esq., on the other hand, for the contrary construction of the proposal. In the absence of an agreement to the contrary, the laws of many states, including California, provide for a general partnership liquidation value on death based on the pro-rata share of the entity value without a minority interest discount. See, Cal. Corp. Code §16701(b). The principal author of this article litigated (but settled this issue) as part of a docketed Tax Court case in *Estate of Hanson v. Comr.*, Tax Court Docket number 016607-04. Accordingly, the second illustration on the valuation impact in this editorial applies the construction that as reasonably construed the minimum value test sets a floor for valuation of family-controlled businesses, indirectly or implicitly, when any disregarded restriction exists (as they most always will under the test of the proposed regulation). Moreover, even if the minimum value does not establish the base and only arises to determine if a restriction should be disregarded and value of a put in the context of determining whether the restriction should be disregarded, the interest of the family members nonetheless will be valued applying extraordinary assumptions inconsistent with traditional objective valuation principles to a substantial degree. These extraordinary assumptions likely increase the value when compared to non-family ownership and cause the appraiser to apply assumptions inconsistent with traditional valuation.

9. *Ibid.*

10. Net asset value is not necessarily limited to only hard assets. See, Akers Commentary *supra*.

11. See, §25.2704-3(b).

12. The relief afforded operating companies is narrow and does not solve the fundamental unfairness of the proposed regulations. Under Reg. §25.2704-2(b)(4)(i), third party restrictions are respected if commercially reasonable and as a condition for providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. This phrase exists in the current regulations. Yet, exceptions in the existing regulations render the limitation on furnishing capital sufficiently narrow to have broad impact. The expansion of the regulations proposed renders the limitation too narrow and unworkable if the proposed regulations are finalized. Several examples illustrate this point. First, non-family members may become owners without furnishing capital (such as an employment incentive) or they may have already furnished

*the capital and the owners want to amend an existing agreement. In each of these practical examples, the limited relief in the regulations does not appear to apply. Second, the minimum worth test in its most benign interpretation forces family-controlled businesses into unjust, prejudicial, overly complex litigation (both tax and non-tax) and reduces, if not eliminates, established discounts and valuation assumptions which actually reduce the value of the family business interest. For example, Section 701 of the Revised Uniform Partnership Act (RUPA) provides a default purchase and sales price if the partnership agreement does not otherwise fix the price. The Official Comments to RUPA Section 701 (paragraph 1), recites that the rights under Article 7 of RUPA, "can, of course, be varied in the partnership agreement, See, Section 103." Paragraph 7 of the Official Comments to this section states, in part:*

*The Section 701 rules are merely default rules. The partners may, in the partnership agreement, fix the method or formula for determining the buyout price and all of the other terms and conditions of the buyout right. Indeed, the very right to the buyout itself may be modified, although a provision providing for a complete forfeiture would probable not be enforceable. See Section 104(a).*

*Section 701, paragraph 3 to the Official Comments states, in part:*

*Under general principles of valuation, the hypothetical selling price... should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner may be appropriate, however.*

*As a result, even if the Proposed Regulations do not directly create a put right in family controlled entities, general partners may be forced into an effective put right valuation since the traditional fair market value pricing appears to create a disregarded restriction. This follows because once the Proposed Regulations disregard any put right at less than the "minimum value" which would seem to include a liquidation or put right at an otherwise appropriate valuation formula based on traditional fair market value principles, the default rule for general partnerships imposes a liquidation assumption that eliminates the minority interest discount.*

*Third, restrictions can arise from third-party terms and conditions that are commercially reasonable yet are not connected with providing loans or obtaining equity for the party imposing the restrictions. For example, franchising contracts commonly impose a host of restrictions, most pertaining to operations and others limiting the transfer of ownership interests by the franchisee. Yet, the restrictions are disregarded if the franchisor is not be "providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. " What if the franchisor is not providing capital for these limited purposes? What if the franchisee pays a franchise fee and the franchisor provides a host of marketing support, supplies and other facilities and restrictions without acquiring capital to the entity in the form of debt or equity? Are the reasonable restrictions to then be disregarded respecting liquidation or transfer of interests notwithstanding the fact that they arose for commercially reasonable purposes yet not for the limited purposes recited in the regulations? The language of the regulations creates that result. If the restriction (such as the requirement in a franchise agreement that one family*

member own at least 51% of the entity or that the estate must have approval of the transferee on sale (and thus cannot sell an interest to a competitor) are not respected, then Reg. §25.2704-2(b)(4)(i) requires valuation without the restriction on transferability. Thus, competitors, or really anyone the law would allow to be an owner are assumed to become potential transferees and the value of the estate's interest is artificially inflated. A competitor might pay a premium to have voting rights, inspection rights (arising from a specified ownership percentage under state law) or the ability to elect a director may enter into the valuation analysis if the restriction is disregarded. In a high-profile twist of the foregoing, consider the professional sports franchise (such as a team in the NFL, major league baseball, the NBA, etc.) in which limitations are imposed on the number of owners of the team and transferability of interests. If the league is not providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity, the restrictions on transferability do not count. They are disregarded restrictions. Just how much more could a selling estate or individual receive for their interest if no restriction existed to obtain consent of a supermajority, or any percentage, of the other owners? Consider what the government of China might want to pay to own a share of the Dallas Cowboys, Los Angeles Rams, San Francisco Giants, New York Yankees or other high profile team as part of its cultural marketing. If the league restrictions do not fall within the narrow allowances quoted above for the exception to apply, a transfer tax appraisal war will likely ensue over the impact of assumed freedom of transferability. Yet, the decedent's estate will still be limited by the restrictions in the league by-laws or other contracts when current ownership seeks to transfer interests in the team. To complicate further the application of the limited exception in Reg. §25.2704-2(b)(4)(i), consider the situation if capital is provided for a purpose indicated though not to the operating entity for its trade or business. The team ownership may be held in one entity, yet sky boxes, stadiums and rental operations held in another entity. Will the providing of financing to one entity enable the exception to apply to the trade or business in another entity? Finally, consider restrictions that arise after the financing has been provided and no additional financing is provided relative to a later restriction or amendment to a restriction. Will the exception still apply? The regulations are vague on this point. In the bottom line, it is impossible to consider all of the situations in which the regulatory assumptions to accept certain business terms but not others. The thrust of the expansion to the proposed regulations to trade or businesses and the assets, affiliates and related entities that support the trade or business creates in its essential nature collisions between novel valuation assumptions forced upon family business and the reasonable commercial arrangements made in the course of legitimate enterprise. No one can see all of the traps when trying to twist and create exceptions to the fundamentally flawed premise that the proposed restrictions should apply at all to legitimate trade or businesses, farms, leasing and other endeavors of closely-held business among family owners.

13. The following provides a detail of the federal and state tax computations that support the summary provided in the main body. The federal deduction for the state death tax is included in the computation.

	<b>Identical Business Not Family Controlled</b>	<b>Family Controlled Business</b>
Valuation of a minority interest (Enterprise value of \$100M)	\$70 M traditional valuation- (30% discounts for minority interest and lack of marketability)	\$95 M (discounts reduced to 5% for lack of marketability)
Federal estate tax	\$28M (.4x \$70M)	\$38M(.4 x \$95M)
Federal estate tax rate as percentage of traditional value	40% (28/70)	54% (38/70)
State death tax rate	16% (New York rate among several other states)	16% (New York rate among several other states)
State death tax, net the 40% federal estate tax deduction	9.6%	9.6%
Effective state death tax, net	\$6,720,000 (9.6 x \$70M)	\$9,120,000 (9.6 x \$95M)
Overall state and federal death taxes as % of traditional value	\$34,720,000 (\$28M + \$6,720,000)	\$47,120,000 (\$38M + \$9,120,000)
Effective overall federal and state tax rate as percentage of traditional valuation	49.6% (\$34.720/\$70M)	67.31% (\$47.120M/\$70M)

14. Fifteen other states have maximum 16% death tax rate. Washington leads the nation with a 20% death tax rate. Some states have lower rates. The State of Washington does allow a qualified family owned business deduction (QFOBI) equal to the lesser of the value of the business or \$2.5M. Any amount of QFOBI already included in the farm deduction may not be deducted under QFOBI.

15. See endnotes that follow.

16. Rev. Rul. 59-60; Rev. Rul. 93-12. Four authors in one article published by Leimberg Information Services, Inc. (“LISI”) characterize the proposals as a “game changer”—though as proposed on an uneven playing field. In technical summary of the proposals, other authors of commentary summarized the technicalities and impact on family-controlled business:

*Although the details of how the proposed regulations accomplish it are complex, they would, if adopted, apparently eliminate virtually all minority or lack of control discounts for family controlled entities, whether active businesses or not, for gift, estate or generation-skipping transfer tax purposes.*

*As urged in the main text of this editorial, Treasury should issue a public announcement stating what it intended and provide examples to eliminate confusion. Even if the put right at minimum value only applies to determine whether a disregarded restriction exists, valuation discounts will be reduced and some may be eliminated in any event. The three-year look-back rule appears*

created for that purpose. Assume that father (George) and son (Alexander) are partners in a general partnership that owns real estate and holds cash and liquid assets to reduce the need for third-party loans for their automobile dealerships. As a result, the operating company can function with reduced outside borrowing, there is less pressure from leveraging and the cost of capital is reduced. However, the general partnership interest would be valued without any minority interest discount under state law (which follows RUPA, *supra*). Assume that George and Alexander terminate the general partnership and transfer all assets and liabilities to an LLC. However, George, who owned 50% of the general partnership dies within three years of the transfer. As a result, George's LLC interest will be valued as though a general partnership interest with a liquidation of the entity assumed. The minority interest discount that would have been included in the valuation of the LLC interest is lost and the lack of marketability discount will be reduced. Now, the overall enterprise (dealership and financing/leasing provided within the family) will pay vastly more estate tax. However, an identical operation not owned within family control will avoid the added estate tax burden.

17. See, Leimberg Information Services, Inc. ("LISI") which has published a series of commentaries regarding the proposed regulations, including thorough analysis of the technicalities of the proposals. See, Marty Shenkman, Jonathan Blattmachr, Ira S. Herman & Joy Matak: Proposed 2704(b) Regulations Will Zap Discounts, Wealthy Taxpayers and Should Plan ASAP- August 22, 2016, [LISI Archive Message #2448](#); Mitchell M. Gans & Jonathan G. Blattmachr on the Recently Proposed Section 2704 Regulations, August 5, 2016, [LISI Archive Message #2441](#); Steve Oshins and Bob Keebler: Creative Planning Strategies Once the 2704 Regulations Become Final. August 8, 2016, [LISI Archive Message #2442](#); and David Pratt, Dana Foley & Daniel Hatten on the Recently Proposed Section 2704 Regulations: What's All the Hoopla About? August 10, 2016, [LISI Archive Message #2445](#). In addition, see, Akers Commentary, *supra*.

18. Objective fair market value principles focus on the hypothetical willing buyer and willing seller and reject assumptions of behavior by individuals unsupported by the evidence. Reg. §§20.2031-1(b), 20.2031-3, 25.2512-1 and 25.2512-3; Giustina, *supra*; *Morrissey v. Comr.*, 243 F.3<sup>rd</sup> 1145 (9<sup>th</sup> Cir. 2001), *rev'g and remd'g Kaufman v. Comr.*, T.C. Memo 1999-119; *Simplot v. Comr.*, 249 F.3<sup>rd</sup> 1191 (9<sup>th</sup> Cir.), *rev'g* 112 T.C. 130 (1999); *Estate of Jameson v. Comr.*, 269 F.3<sup>rd</sup> 366 (5<sup>th</sup> Cir. 1991), *vacating and rev'g* T.C. Memo 1999-43; *Estate of Elkins v. Comr.*, 140 T.C. No. 5 (2013), *rev'd*, 2014-2 U.S.T.C. ¶ 60,683 (5<sup>th</sup> Cir.). Transgression of objective principles of valuation will arise irrespective of the resolution over whether the minimum value liquidity rule applies at the entity level or merely as part of a test to determine whether restrictions will be considered. In the process of determining objective valuations, appraisal reports cite a variety of studies in the commercial marketplace to establish comparables and studies of valuation adjustments, including discounts. Thus, the tax law criteria look to real world experience. The assumptions demanded by the regulations are devoid of real world criteria or analysis. The artificially-high valuation imposed by the family business penalty will create liability risks for fiduciaries who purchase assets from family members (whether as part of a trust or business deal). Beneficiaries may assert that the price paid exceeded sound business valuation principles. Hopefully, the IRS will have some compassion for not imposing artificial valuations that create significant traps for fiduciaries and professionals who draft trusts or implement purchases and sales in a fiduciary setting.

19. *The discounted cash flow (DCF) method of valuation of business as a whole has received extensive support within the business community, appraisal industry, the IRS and the Tax Court. See, Estate of Heck v. Comr., T.C. Memo 2002-24; Estate of Jung v. Comr., 101 T.C. 412 (1993); Estate of True v. Comr., T. C. Memo 2001-167, aff'd 390 F.3<sup>rd</sup> 1210 (10<sup>th</sup> Cir. 2004). However, the proposed regulations impose a net asset value minimum worth test on short-term liquidation (under a put right) notwithstanding lack of control of the decedent over the family enterprise. See, point-counterpoint discussion in Akers Commentary and Prop. Reg. §25.2704-3(b)(iv)(D). The put right requirement makes it more expensive for the family bringing in non-family members as significant co-owners. There is an exception to the disqualified restriction when the condition is demanded by a non-family member who satisfies the ownership tests when the restriction is demanded as a condition to contribute capital. However, that exception does not cover the situation when capital has already been contributed and the modification to the agreement that includes a new or revised restricted condition is subsequently added to the agreement.*

20. *Mel Abraham, a co-contributor to this editorial, observes, "The fair market value standard of value would be dead in my mind as this would disregard the hypothetical nature of the buyer and seller. It would also disregard the facts that are known and knowable as required by the standard." See, case discussion in each of the prior two endnotes. Mr. Abraham (among other appraisers) notes that intensive and more complex issues for valuers will need to be addressed in the appraisal process to consider some very specific factors that impact value but are not marketability or control. For instance key person, lack of depth of management, unique operating risks, and personal goodwill issues will become more prominent. Appraisers will be required to a greater extent than they currently are in order to probe deeper in the analysis of the individual components of risk associated with family entity holdings.*

21. *Propstra v. U.S. , 680 F.2d 1248 (9th Cir. 1982); Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Minahan v. Comr., 88 T.C. 492 (1987) - IRS sanctioned.*

22. *Reg. §25.2704-3(b)(ii). The rationale for this limitation is perplexing and will create more problems. Is this an attack on deductions allowed under generally accepted accounting principles? Moreover, some debt does reduce value yet is not subject to a claim. For example, non-recourse debt is not a claim against an estate. Reg. §20.2053-7. Moreover, the regulations under IRC §2053 generally limit deductions to amounts actually paid, not an estimate or reasonable amount of the deduction. Conditions may exist with respect to assets that reduce value but which are not deductions under IRC §2053. For example, some adverse environmental conditions or easement issues may not create third party claims yet reduce the value of the real estate.*

23. *The Treasury/IRS proposal presents an ironic twist to the famous bar scene in the film Goodwill Hunting wherein Matt Damon's character (Will Hunting) confronts a conceited Harvard graduate student (a Michael Bolton look-alike). The graduate student presented as his own words obscure statements from historic textbooks (by Vickers and Wood) in order to "impress some girls" and embarrass Hunting's friend (portrayed by Ben Affleck). In that setting the graduate student starts the following statement that Damon's character finishes, "drastically -- Wood 'drastically underestimates the impact of social distinctions predicated upon wealth,*



*especially inherited wealth.” First no one can accuse the IRS or Treasury of being unoriginal. The proposed regulations create original assumptions divorced from factual basis, disregard business succession aims and pursue direction without a compass connecting the required assumptions to a historic foundation. At the same time, the proposals do not underestimate the value of any social distinctions. To the contrary, the proposed regulations inflate the value of social distinctions with business succession and ownership by assigning an expensive premium discriminatory against only the family-controlled ownership of inherited wealth.*

*24. Family owners of companies that plow profits back into the business bear that harshest blow since the reduced liquidity arising from reinvestment is disregarded when liquidity is assumed. Going concern value is minimized or disregarded. Deferral to pay estate tax under IRC §6166 delays imposition of the tax pain for closely-held business ownership but does not fix the injustices or total added burden to family businesses proposed in the regulations.*

*25. Estate of Maddox v. Comr., 93 T.C. 228 (1989); Estate of Hoover v. Comr., 69 F. 3<sup>rd</sup> 1044 (10<sup>th</sup> Cir. 1994).*

*26. Currently, \$5,450,000 with annual adjustments. Proposals have been introduced in Congress to reduce the amount to \$3,500,000.*

*27. See, Reg. §1.1014-3, IRC §1014(f) and Rev. Rul. 66-56. Income tax basis consistency rules do not apply to estates that are not required to file an estate tax return or to assets in the gross estate (regardless of the value of the gross estate) that qualify fully for the estate tax marital deduction. The proposed regulations apply for estate, gift and GST purposes, but not expressly for income tax purposes.*

*28. In recent years, the IRS has received extensive and reasoned communication from leading tax practitioners regarding the questionable legality and wrongfulness of its proposals from the standpoint of legislative history and IRS/Treasury authority. Richard Dees, Esq., partner at McDermott, Will & Emery, LLP, authored an extensive letter to Treasury and the IRS, which was being considered by the addressees prior to issuance of the proposed regulations. See Richard L. Dees, Attorney Criticizes Possible Changes to Valuation Discount Rules, appearing in Tax Notes Today published by Tax Analysts® on August 31, 2015. James G. Blase, Esq., a co-author of this editorial, in writing for Trusts & Estates has challenged the authority of the IRS to change the control test from the transferor “and” members of his family to a standard of the transferor “and/or” members of his family, under Prop. Reg. §§25.2704-1(a)(1) and 25.2704-2(a), as well as several other portions of the proposed regulations. See, <http://wealthmanagement.com/estate-planning/portions-proposed-2704-regulations-exceed-irs-authority> and <http://wealthmanagement.com/valuations/portions-proposed-2704-regulations-exceed-irs-authority-part-2>*

*29. House Report No 964, 101<sup>st</sup> Congress Second Session 1137 (1990). The Conference Committee Report states:*

## *Treatment of certain restrictions and lapsing rights*

### *In general*

*The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of [Estate of Harrison v. Commissioner, 52 T.C.M. \(CCH\) 1306 \(1987\)](#). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law. (Emphasis added.)*

*30. See, Richard Dees letter, supra. The proposed regulations both affect (i.e., reduce discounts) and in some instances eliminate discounts. Treasury over-reached in its proposals, opting for a massive assault against traditional valuation rules where a surgical approach to address points of greatest concern within the law could have been proposed. It appears that the taxing authorities assert a standard of “not eliminating” rather than “not effecting” discounts for their regulatory discretion notwithstanding the foregoing legislative record. Yet, even if the legislative history or regulatory authority could be construed to apply a “not eliminate” standard, the proposed regulations violate that criteria. The Treasury and the IRS appear to have gone beyond the changes of law contemplated by recent legislative proposals in the administration’s “Green Book.” Ultimately, the Tax Court, the Courts of Appeal and perhaps the Supreme Court will resolve the legality of the final regulations. Taxpayers will face multi-million dollar litigation to challenge the regulations if finalized while unsettling business succession for families in the interim. Charles Morris, Esq., former Western United States Territory Manager for Estate & Gift Tax Compliance observes:*

*As a former revenue officer I understand the frustration IRS feels around that loss in Kerr. What I don’t understand is how we got from Rev Rul. 93-12 to these proposed regulations. Rev Rul 93-12 was issued during a Democratic administration well after the implementation of Chapter 14. 93-12 is consistent with the legislative history for IRC 2704. How now can we have a regulation issued that’s contrary to both? I am confident the proposed regulations if enacted as is would be shot down in our court system. The IRS is out of bounds here. Leave this to the Green Book and a more thoughtful group in Congress. This reg has too many loose ends (in the details) to boot. I think they could have accomplished a more limited clean up as to what happened in Kerr.*

*31. The proposed regulations create a new three-year rule that will result in a taxable gift (or added estate tax) arising if a liquidation right is restricted or eliminated within three years of death. Treasury’s proposal disregards the fact that IRC §2035 repealed the old gift in contemplation of death rule and permitted a three-year look back in a very limited context. This usurps legislative authority. Of greater concern to business owners, the look-back rule will leave unsettled business succession planning, create “phantom” value in estates unsupported by actual assets or value received and compound the unfairness faced by family-controlled business. (See the example of George and Alexander in endnote xvi, supra.) The notice to proposed regulations cites the decision in *Estate of Murphy* 60 T.C.M. 645 (1990), in which a*

*death-bed gift of control was disregarded. The notice does not cite Estate of Frank v. Comr., 69 T.C.M. 255 (1995) wherein no gifted interest that increased discounts shortly before death was brought back into the gross estate.*

*32. Reference to Shakespeare's play, King Lear, applies in which two of the children turn on their father once they receive the control of kingdom. After he made the gifts he wished he had retained control and wealth.*

*33. Note that a lack of marketability discount can apply to a controlling interest. See, for example, Estate of Trenchard v. Comr., T.C. Memo 1995-121; Estate of Gray v. Comr., T.C. Memo 1997-67; (marketability discount applied to controlling interest); Bennett Est. v. Comr., T.C. Memo 1993-34 (same); though denied in Estate of Jephson, 87 T.C. 297 (1986) when underlying assets were liquid.*

*34. Estate of Adams v. Comr., 99-1 U.S.T.C. Par. 60,340 (N.D. TX 1999), rev'd 218 F.3<sup>rd</sup> 383 (5<sup>th</sup> Cir. 2000), retried and judgment entered 2001-2 U.S.T.C. Par. 428 (N.D. TX); Estate of Kerr v. Comr., 113 T.C. 449 (1989), aff'd 292 F.3<sup>rd</sup> 490 (5<sup>th</sup> Cir. 2002); Estate of Koons v. Comr., T.C. Memo 2013-94.*

*35. Existing court cases enable the IRS to set aside death bed transfer in situations in which death bed transfers are not legitimate.*

*36. IRC §2704(b). The regulations disregard assumptions of legitimate terms of the business deal for tax purposes notwithstanding the fact that existing law authorizes regulations that reduce value if the restriction does not also reduce the value of such interest to the transferee. Business agreements commonly move voting interests to non-voting interests unless the assignee is approved by the members and other conditions are satisfied.*

*37. The elimination of the minority interest discount and the reduction of the lack of marketability discount that have been a part of business ownership valuation for at least five decades will be imposed against family businesses.*

*38. Seventy percent of family-owned businesses liquidate on the death or incapacity of the principal owner. Liquidation most commonly arises because there is not an effective succession plan in place or the business owner has not focused on the continuation of the business after death or incapacity.*

*39. The regulations allow family members to use a promissory note other than with a six-month assumption in a narrow context setting. Allowance in a narrow setting, likely to raise extensive dispute in practice, is extended to a secured promissory note meeting certain conditions to be paid with respect to operating assets in a trade or business. Even this apparent exception will be fraught with practical drawbacks in the real world. For example, if shares of a corporation are redeemed, the shares under the law of the state (such as California) will no longer exist as issued and outstanding shares. Unless the corporation or its shareholders provide security in the form of other assets, the note will be unsecured and extended payment terms are denied within the exception under the minimum value put test. The ability of the corporation to grant collateral*

*from its own assets is commonly limited by requirements of lenders and pre-existing covenants of creditors. Moreover, due-on-sales clauses with deeds of trust (mortgages) may include acceleration rights in the event of subsequent encumbrances. In a setting of this practical type, the other shareholders will then need to provide guarantees to secure the loan. However, will those guarantees provide “adequate security”? IRS estate tax attorneys may demand to see financial statements to evidence the sufficiency of the guarantees. Thus, in order to satisfy the test for an extended payment, the privacy of surviving shareholders will be infringed when the production of financial statements are not required under normal business terms even when guarantees are provided in this context. The execution of guarantees is not uncommon in business to secure corporate (or other entity) debt. However, it is not universally required; and for successful companies commercial lenders may not require a guaranty. In fact, the Tax Court ruled, and the IRS agrees, that extended payment of federal estate tax is available without security if the profitability and track record of the entity are sufficient within reasonable discretion. See, Estate of Roski v. Comr., 128 T.C. 113 (2007); IRS Notice 2007-90; and, IRS Chief Counsel Advisory 200803016. Furthermore, the allowance for the payment of terms under a secured promissory note exception to disregarded restrictions requires that the entity is “engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B).” How will the 60% test will be applied when the enterprise includes an operating company and related entities that contribute to the overall enterprise, such as with land, financing, equipment and other assets will create unique challenges and uncertainties for the family enterprise? The closely-held business exception for deferral of estate tax does not require a 60% non-passive ownership test. Rather, the deferral allowance applies only to non-passive assets as that term is defined under IRC §6166 and authority. Thus, even when the proposed regulations grant elements of relief for trade or business ownership, they impose additional tough conditions and tests on the family that defy customary business practices and norms and which are not suffered by non-family businesses.*